19.02 Admission of a New Partner

When partners admit a new partner into the partnership, there are *three different methods* that may be applied, depending on the terms under which the partner is being admitted. These are the bonus method, the goodwill method, and the exact method.

- Increase capital by contribution.
- Determine if capital equals agreement as to share. If not, then adjust using one of the following methods:
  - **Bonus method** – When the purchase price is different than the book value of the capital account purchased, bonuses are adjusted between the old and new partners' capital accounts and do not affect partnership assets.
    - Old partners share bonus based on profit and loss ratio prior to admission of new partner (**Bonus Adjust the Right – BAR**).
  - **Goodwill method** – Goodwill is recognized based upon the total value of the partnership implied by the new partner's contribution (**Goodwill Adjust the Left – GAL**).
  - **Exact method** – No goodwill or bonus is recorded. New partner capital account is equal to the assets contributed.

The **admission of a new partner** to a business often requires a reallocation of the capital balances of both the new and old partners. When this occurs, the method of reallocation that is normally used is the **bonus method (adjust the Right)**, in which the new partner transfers sufficient capital to the old partners to leave the new partner with the desired capital allocation (in rare cases, the old partners pay the bonus to the new one).

For example, assume that the DanDee partnership has two partners, Dan and Dee, who share profits on a **3:2 basis** and have capital balances of **$30 and $100**, respectively. Lyon is admitted to a **1/6 interest** in initial capital and profits in exchange for a **$50 contribution** to the partnership. The contribution may be recorded:

Cash	50	
Lyon, capital		50

At this point, however, total capital is $30 + $100 + $50 = $180, and Lyon's share of initial capital of $50 / $180 does **not** equal the 1/6 agreement. Since 1/6 of $180 is $30, not $50, Lyon will have to pay a $20 bonus to Dan and Dee, who share such bonuses as they share profits, 3 to 2.

The adjustment is as follows:

Capital	Net assets	Dan	Dee	Lyon
Before admission	130	30	100	
Contribution	50			50
Subtotal	180	30	100	50
Bonus		12	8	-20
After admission	180	42	108	30

Bonus (Adjust the Right)

Cash	50	
Capital – Lyon		30
Capital – Dan		12
Capital – Dee		8

Alternatively, the partnership may use the **goodwill method (adjust the Left)**, in which goodwill is recorded and added to the old partners' capital balances (or in rare cases, that of the new partner), so that total capital is increased to achieve the desired ratio.

In this example, Lyon paid **$50 to own 1/6** of the company, so the implied value of the company is $50 × 6 = $300. Since capital equaled $180 before recording goodwill, implied goodwill is $300 - $180 = $120, and the adjustment is as follows:

Capital	Net assets	Dan	Dee	Lyon
Before admission	130	30	100	
Contribution	50			50
Subtotal	180	30	100	50
Goodwill	120	72	48	
After admission	300	102	148	50

Goodwill (Adjust the Left)

Cash	50	
Goodwill	120	
Capital – Lyon		50
Capital – Dan (120 × 60%)		72
Capital – Dee (120 × 40%)		48

Occasionally, a partnership wishes to admit a partner and provide them with a certain fraction of initial capital **without recording either a bonus or goodwill (Exact method).** In this case, the new partner must pay an amount to the partnership that will result in the desired initial capital allocation.

For Dan and Dee to admit Lyon in this manner with a 1/6 interest in initial capital, Dan and Dee's combined accounts of $130 before admission must represent 5/6 of the new total capital. **$130 × 6 / 5 = $156**, so Lyon must contribute $156 - $130 = $26, as follows:

Capital	Net assets	Dan	Dee	Lyon
Before admission	130	30	100	
Contribution	26			26
After admission	156	30	100	26

Notice that $26/$156 = 1/6 already, with no need for an adjustment.

Exact method

Cash	26	
Capital – Lyon		26

Retirement & Liquidation

When a **partner retires**, several adjustments usually need to be made:

1. Assets and liabilities are adjusted to fair market value (including goodwill) to determine the value of the retiring partner's interest.
2. The retiring partner's account is reduced by the retirement payment.
3. If the retiring partner's account is reduced below $0, a bonus is paid to adjust it properly, with the other partners paying the cost based on their relative shares of profits and losses (in rare cases, the retiring partner's account is above $0 and the bonus is paid to the surviving partners).

For example, assume that the DanDeeLyon Partnership's three partners, Dan, Dee, and Lyon, share profits and losses on a 3:2:1 basis and have capital accounts of $30, $100, and $50, respectively. Lyon retires: the partnership net assets are appraised at an amount $120 higher than book value, and Lyon is then paid $80 at retirement. The computation of the capital balances of the surviving partners, Dan and Dee, is as follows:

Capital	**Net assets**	**Dan**	**Dee**	**Lyon**
Before retirement	180	30	100	50
Appraisal	120	60	40	20
Subtotal	300	90	140	70
Payment	(80)			(80)
Subtotal	220	90	140	(10)
Bonus		(6)	(4)	10
After retirement	220	84	136	--

When a **partnership liquidates** immediately, all of the assets and liabilities are reduced to cash, with gains and losses reported on sold assets. The resulting capital balances may represent the payments to the partners, but if one partner has been reduced to a deficit (debit) balance in capital, they often do not pay the indicated amount. In such cases, they are credited with a bonus to increase capital to $0, and the amount is taken from the other partners based on their relative sharing of losses.

- Assume all non-cash assets are sold for $0.
- Allocate the loss to all the partners based on their profit/loss percentages.
- If one partner has a deficit balance, allocate the deficit balance to the remaining partners based on their new profit/loss percentages.

For example, assume that the Dan Dee Lyon Partnership, with partners sharing profits and losses **3:2:1 and with capital balances of $30 for Dan, $100 for Dee, and $50 for Lyon, liquidates.** The sale of assets results in a **$120 loss**. The payments to the partners are computed as follows:

Capital	Net assets	Dan	Dee	Lyon
Before liquidation	180	30	100	50
Realized losses	(120)	(60)	(40)	(20)
Subtotal	60	(30)	60	30
Dan's bonus		30	(20)	(10)
Payments	60	0	40	20

In an **installment liquidation**, assets may be sold in stages. In the first stage, all assets not yet sold are written off as a total loss (because of the conservatism principle and since they aren't in cash

form and cannot be used to pay partners yet). Any bonus reallocation is made as noted above. The steps involved in later stages appear to be beyond the scope of CPA exam testing.

Joint & Several Liability

Partners in a partnership are said to be jointly and severally liable for the obligations of the partnership. This indicates that a third party with a legitimate claim against the partnership may be successful in an action against any of the partners or all of the partners collectively. As a result, a partner paying a disproportionate amount of the claim will have a claim against the other partners. (ASC 405)

When a reporting entity is involved in an arrangement that creates joint and several liability, that entity, referred to as an obligor, may be required to recognize a liability. A liability will be accrued if the amount of the liability is fixed as of the reporting date and the obligation is not subject to some other authoritative method of accounting.

The amount that will be recognized as a liability will be the total of:

- The amount the obligor is required to pay under the arrangement with co-obligors.
- Additional amounts that the entity expects to pay on behalf of co-obligors.

When a liability is recognized, the offset may be to:

- Cash if the obligation is debt related.
- Expense if the obligation resulted from a loss such as an unfavorable legal settlement.
- A receivable, such as from a co-obligor, subject to evaluation for impairment or collectability.
- An equity account as a result of a transaction with an entity under common control.